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DE RUEHFT #3330/01 3111207
ZNR UUUUU ZZH
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FM AMCONSUL FRANKFURT
TO RUEHC/SECSTATE WASHDC IMMEDIATE 8497
INFO RUEATRS/DEPT OF TREASURY WASHDC IMMEDIATE
RUCNMEM/EU MEMBER STATES IMMEDIATE
RUCNFRG/FRG COLLECTIVE IMMEDIATE

UNCLAS SECTION 01 OF 02 FRANKFURT 003330

STATE FOR EEB(NELSON),EEB/OMA(SAKAUE, WHITTINGTON), DRL/ILCSR AND
EUR/AGS
TREASURY FOR ICN(KOHLER),IMB(MURDEN,MONROE,CARNES),OASIA

SIPDIS

E.O. 12958: N/A
TAGS: ECON EFIN GM
SUBJECT: Commerzbank Deal Reveals Flexibility in Stabilization Fund

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Ref: Frankfurt 3260, Berlin 1452, Berlin 1414

¶1. Summary: (SBU) Commerzbank, Germany's second largest bank, became the largest bank to date to take part in the government's Financial Market Stabilization Fund (FMSF). The bank secured key concessions, thus avoiding some of the more invasive aspects of the fund. The European Commission announced it would look into the deal saying Commerzbank may have paid too little for capital. Although many argued the FMSF was structured poorly and would not attract many takers, Commerzbank's move indicates that the fund may attract more banks, and that the government will relax certain elements of the fund. This small step forward gives hope that normal market conditions will slowly take hold in the financial sector as officials at the European Central Bank (ECB) admit that their efforts have prevented a collapse of the financial system without offering a real way forward. End Summary.

"A Sweetheart Deal" for Commerzbank

¶2. (U) After revealing a third-quarter net loss of 285 million euros ($362 million) November 3, Commerzbank announced it would accept an 8.2 billion euro ($10.4 billion) capital injection as well as 15 billion euros ($19 billion) in loan guarantees, making it the largest German bank to take advantage of the state's financial stabilization fund. In exchange, the Germany government will take a silent holding in the bank. The European Commission has promised to investigate whether the deal is in compliance with competitiveness requirements as Commerzbank is set to pay 8.5% and 5.5% interest on two tranches of capital, amounts below the 10% minimum Brussels requires.

¶3. (U) Commerzbank joins Hypo Real Estate (another private bank) and BayernLB, WestLB, and HSH Nordbank (all state banks) in asking the state for help. Commerzbank CEO Martin Blessing cited the bank's need to raise its Tier 1 capital ratio from 7.3% to 11.2% in order to deal with turbulent market conditions. Raising capital will also put Commerzbank on surer footing as it goes forward with plans to take over Dresdner Bank. The government will be required to sell its stake in Commerzbank at the end of 2009, but the deal could be extended by the Ministry of Finance if market conditions have not improved.

¶4. (SBU) Commerzbank Executive Vice-President Christof Maetze told ConGen Econ Off that the bank had negotiated specific terms with the government, gaining the concession that the Ministry of Finance will not be able to dictate any investment decisions to the supervisory board. He argued that Finance Minister Peer Steinbrueck gave away very little with this decision as the combined Commerz-Dresdner entity will already be a leading lender to German industry and small and medium-sized enterprises, which is the type of lending he wishes to stimulate. The condition that Commerzbank freeze dividend

payments through 2009 will also have a minimal impact as dividends were expected to be low during the assimilation of Dresdner. Members of the Commerzbank Managing Board will, however, accept lower salaries of 500,000 euros ($637,000), while bonuses will also be limited. Maetze optimistically described the agreement at as "a sweetheart deal" admitting that Commerzbank got funding on very good terms.

Loan Guarantees Offer Way Forward

¶5. (SBU) Commerzbank's acceptance of loan guarantees gives hope that the FMSF will revitalize the moribund interbank lending market. Maetze argued that rather than stigmatizing banks, participation in the fund was viewed positively by other banks, especially those who also were taking part, as state-backing raised confidence in counterparties. He said that small positive trends were already apparent: Euribor and Libor spreads (measures of interbank lending rates) had decreased, while lending volume was slightly up. Commerzbank intended to use the state guarantees to offer 3-5 year term lending, a market which had largely dried up in recent times.

¶6. (SBU) European Central Bank Deputy (ECB) Director for Monetary Operations Paul Mercier confirmed to Congen Econ Off that monetary operations (whereby the ECB provides short-term liquidity to banks in exchange for collateral) have replaced the interbank lending market. Mercier said "Our job was to make sure the patient (the financial system) did not die, but now the patient is addicted to the medicine (short-term liquidity)." Monetary operations now worked "as the opposite of an incentive" to get banks to start lending to each other. He added that the ECB has no exit strategy

to draw down the operations and reinvigoate interbank lending. The loan guarantees offeed through the FMSF offer the best hope of restoing interbank lending, although non-collateralized non-guaranteed lending is still not on the horizon.

¶7. (SBU) Both Maetze and Mercier agreed tha when the turbulence dies down, the financial setor will have to deal wit market distortions created by government intervntion. As the EU's concerns about the terms of he deal reveal, capital injections and loan guarntees will distort competitiveness in the industry artificially boosting those who get the best dea. Additionally, a return to the halcyon days oflow transaction fees and mutual confidence may nver take place. The new financial order will most likely be one of higher operating costs and lowe returns, but hopefully also one better poised toavert future crises.

¶8. (SBU) Comment: Commerzank's entry into the FMSF gives hope that the fud will work as designed and bring in a range of participants. It also shows, however, that banks that are not in deep trouble will take part only when the terms are favorable. In this case, the Ministry of Finance, having earlier been criticized for designing an unattractive rescue package, has shown a willingness to give banks very favorable terms, even at the risk of creating a backlash in the EU. End Comment.

¶9. This cable was coordinated with Embassy Berlin.
POWELL